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# Depreciation of Pipeline Easement Costs

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specified amount of money without forfeiting welfare benefits. But there is no incentive to earn additional money since earning even one dollar above the specified amount will result in forfeiture of welfare payments. Under the proper program incentive might be retained. One suggested approach calls for the use of a negative income tax.<sup>73</sup> This approach would grant a specified amount of income to a basic family unit and then tax any additional income earned by the recipient at a comparatively high (e.g., fifty per cent) tax rate until the total amount of income adjusted by the high tax equals the amount of disposable income under the positive tax system. In effect, the negative income tax system provides each eligible recipient with a minimum income and then reduces the net benefit proportionately by the amount of money earned by the recipient. Thus, contrary to present state programs, incentive to earn money is not reduced at any given point.<sup>74</sup> But regardless of whether a negative income tax or any other federal approach is adopted, it is apparent that *Green* heralds some sort of social reform.

Stanley R. Huller

### Depreciation of Pipeline Easement Costs

Shell Pipe Line Corporation transports crude oil and petroleum products through a pipeline system composed of gathering lines, secondary trunk lines, and primary trunk lines.<sup>1</sup> For federal income tax purposes Shell was allowed to depreciate its right-of-way easement costs only for its gathering lines.<sup>2</sup> Shell brought suit in the District Court for the Southern District of Texas for refund of excess income taxes paid, claiming that it should be allowed to depreciate both primary and secondary trunk line easement costs as well. Prior to trial, the Internal Revenue Service conceded that Shell was entitled to a depreciation deduction for its secondary pipeline rights-of-way, leaving in issue only the deduction claimed for the primary trunk line rights-of-way. *Held*: Primary trunk line rights-of-way costs incurred by an oil pipeline common carrier are depreciable because such assets have a limited useful life which can be estimated with reasonable accuracy. *Shell Pipe Line Corp. v. United States*, 267 F. Supp. 1014 (S.D. Tex. 1967).

#### I. INVESTMENTS IN PIPELINE RIGHTS-OF-WAY

The typical pipeline right-of-way agreement involves the payment of a lump sum for the privilege of laying and maintaining the pipeline.<sup>3</sup> The

<sup>73</sup> See Tobin, *Is a Negative Income Tax Practical?*, 77 YALE L.J. 1 (1967).

<sup>74</sup> It is recognized that neither program can actually compel a recipient to work at all. However, the negative income tax approach at least does not discourage those who are willing to work.

<sup>1</sup> This classification is used by Shell Pipe Line Corporation only for tax purposes. It is not prescribed by the Interstate Commerce Commission system of accounting, which distinguishes only between gathering systems and trunk systems.

<sup>2</sup> During the years 1930-1943 the Internal Revenue Service allowed a depreciation deduction on all pipeline rights-of-way. However, since 1943 the Internal Revenue Service has refused to allow Shell and all other such pipeline companies a depreciation deduction on the capitalized costs of its primary and secondary pipeline rights-of-way.

term of the right-of-way grant is generally indefinite, existing as long as the pipeline is maintained. Frequently, the right-of-way agreement contains "second line rights" whereby an additional line may be laid over or parallel to the original right-of-way. If "second line rights" are available the usual procedure is for the pipeline company to agree to pay the same consideration that was paid for the original grant when the additional lines are laid.<sup>4</sup>

Rights-of-way are acquired by purchase and condemnation at substantial costs. These costs are separated for accounting purposes from the costs involved in laying the pipeline itself, usually in a right-of-way account. This account normally includes not only the costs of obtaining the easements, but also related costs, such as the salaries of the employees who negotiated with the landowners, court costs in condemnation proceedings, clearing and grading costs, damage costs, and other related items.<sup>5</sup>

Since the right-of-way is expected to be useful in future years, it is not deductible in the year of purchase as a business expense. Rather, the cost of the right-of-way must be capitalized.<sup>6</sup> Instead of requiring the taxpayer to wait until the easement is abandoned before deducting its cost, the Revenue Service has recognized that a right-of-way easement grant might be a proper subject for depreciation.<sup>7</sup> However, the Revenue Service<sup>8</sup> and the courts<sup>9</sup> have assumed without discussion or authority that the pipeline rights-of-way are intangibles. Thus, many pipeline companies have been denied a depreciation deduction because they could not show that their intangible rights-of-way had a limited useful life which could be estimated with reasonable accuracy. Both the Interstate Commerce Commission<sup>10</sup> and the Federal Power Commission,<sup>11</sup> regulatory agencies for the oil and gas pipelines, have treated pipeline rights-of-way as tangible assets rather than intangibles. Possibly, the regulatory agencies reason that the right-of-way expenditures represent a part of the cost of the pipeline, and such costs, along with the construction costs, line pipe and equipment, become merged into one tangible asset. This alternate classification suggests that the Revenue Service and the courts should consider whether the pipeline rights-of-way are intangibles or tangibles, and not merely assume they are intangibles.

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<sup>3</sup> See *Commonwealth Natural Gas Corp. v. United States*, 266 F. Supp. 298, 301 (E.D. Va. 1966).

<sup>4</sup> *Id.* at 301.

<sup>5</sup> *Shell Pipe Line Corp. v. United States*, 267 F. Supp. 1014, 1016 (S.D. Tex. 1967); *Commonwealth Natural Gas Corp. v. United States*, 266 F. Supp. 298, 301 (E.D. Va. 1966).

<sup>6</sup> *Nachman v. Commissioner*, 191 F.2d 934 (5th Cir. 1951). An expenditure for a capital asset reasonably expected to serve taxpayers in future years cannot be deductible as an ordinary business expense.

<sup>7</sup> Rev. Rul. 65-264, 1965-2 CUM. BULL. 53.

<sup>8</sup> Rev. Rul. 60-317, 1960-2 CUM. BULL. 452; Rev. Rul. 65-264, 1965-2 CUM. BULL. 53.

<sup>9</sup> See *Northern Natural Gas Co. v. O'Malley*, 277 F.2d 128 (8th Cir. 1960); *Shell Pipe Line Corp. v. United States*, 267 F. Supp. 1014 (S.D. Tex. 1967); *Commonwealth Natural Gas Corp. v. United States*, 266 F. Supp. 298 (E.D. Va. 1966).

<sup>10</sup> Uniform System of Accounts for Pipe Line Companies Prescribed by Interstate Commerce Commission, 49 C.F.R. § 20.2-3 (1963).

<sup>11</sup> Uniform System of Accounts Prescribed for Natural Gas Companies by Federal Power Commission, 18 C.F.R. § 201.304 (1960).

The regulations require that two conditions be met in order to qualify for depreciation under section 167 of the Internal Revenue Code:<sup>12</sup> first, the right-of-way must have a limited useful life;<sup>13</sup> and second, the length of the limited useful life must be estimated with reasonable accuracy.<sup>14</sup> Regardless of whether the pipeline rights-of-way are characterized as intangible assets or tangible assets, both of these conditions must be met. However, in the case of an intangible asset proof is frequently more difficult.

*Limited Useful Life.* The regulations provide that the useful life of an asset is not necessarily its actual life but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income.<sup>15</sup> The useful life is determined by reference to either (a) the taxpayer's experience with similar property, taking into account present conditions and probable future developments, or (b) the general experience in the industry if the taxpayer's own experience is inadequate.<sup>16</sup>

When the right-of-way agreement has a fixed term, the useful life for depreciation purposes is the life of the right-of-way as specified in the agreement and no problems are encountered. However, when no term is specified it may be difficult to prove that the useful life of the easement is limited. The primary difficulties arise when the right-of-way agreement contains either renewal privileges or "second line rights." If the right-of-way easement can be renewed indefinitely, it is obvious that the requirement of a limited useful life will not be met.<sup>17</sup> Likewise, the presence of "second line rights" in the original right-of-way agreement places upon the taxpayer the burden<sup>18</sup> of showing that the right-of-way will not be useful in the construction of additional pipelines. Thus "second line rights" may

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<sup>12</sup> INT. REV. CODE of 1954, § 167(a): "There shall be allowed as a depreciation deduction a reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—(1) of property used in trade or business, or (2) of property held for the production of income."

<sup>13</sup> Treas. Reg. 1.167(a)-3 (1956):

If an intangible asset is known from experience or other factors to be of use in the business or in the production of income for only a limited period, the length of which can be estimated with reasonable accuracy, such an intangible asset may be the subject of a depreciation allowance. . . . An intangible asset, the useful life of which is not limited, is not subject to the allowance for depreciation. No allowance will be permitted merely because, in the unsupported opinion of the taxpayer, the intangible asset has a limited useful life.

<sup>14</sup> *Id.*

<sup>15</sup> Treas. Reg. § 1.167(a)-1(b) (1956):

For the purpose of section 167 the estimated useful life of an asset is not necessarily the useful life inherent in the asset but is the period over which the asset may reasonably be expected to be useful to the taxpayer in his trade or business or in the production of his income. This period shall be determined by reference to his experience with similar property taking into account present conditions and probable future developments. . . . If the taxpayer's experience is inadequate, the general experience in the industry may be used until such time as the taxpayer's own experience forms an adequate basis for making the determination.

<sup>16</sup> *Id.*

<sup>17</sup> *Nachman v. Commissioner*, 191 F.2d 934 (5th Cir. 1951).

<sup>18</sup> This is the position of the Revenue Service in Rev. Rul. 65-264, 1965-2 CUM. BULL. 53. The Revenue Service recognizes that this burden will be satisfied where the taxpayer can factually demonstrate that the usefulness of such intangible assets will not extend beyond the expiration of the useful life of a particular pipeline to which such costs are wholly related.

lead to the conclusion that the easement has no limited useful life and is not a proper subject for a depreciation deduction.

*Estimation with Reasonable Accuracy.* The taxpayer not only must establish a limited useful life of his property, but also must estimate with reasonable accuracy the duration of the useful life. One method of estimating the useful life of the right-of-way easements, the "reserve method," is determined by dividing the production in a given year into the total reserves of oil and gas in place and available to the pipeline company. This method was first upheld in 1960 in *Northern Natural Gas Co. v. O'Malley*.<sup>19</sup> The Eighth Circuit allowed depreciation of right-of-way costs, reasoning that the gas reserves available to the pipeline company were a wasting asset and eventually would be fully depleted. The court noted that it would be unreasonable to put upon the taxpayer the burden of proving to a reasonable certainty the amount of depreciation. A "reasonable approximation" of the amount of depreciation in any year is all that is required.

Likewise, in *Commonwealth Natural Gas Corp. v. United States*<sup>20</sup> the district court in Virginia allowed depreciation for the right-of-way easements on the same rationale as in the *Northern Natural Gas* case. The court stated that "natural gas reserves exist in nature in a finite amount" and consequently, "such reserves will be available for a limited time."<sup>21</sup> In determining that the useful life of the reserves was limited the court considered the natural gas which had already been discovered and was known to exist with a great degree of certainty and the undiscovered resources which were expected to be discovered in the future. Thus, in these two cases, *Northern Natural Gas* and *Commonwealth Natural Gas*, the courts determined that the limited useful life could be estimated with reasonable accuracy by the "reserve method." In both cases "the court required little more than proof that the easements would ultimately be valueless, and required very little certainty as to the period within which this would come to pass."<sup>22</sup>

The Internal Revenue Service, however, refused to follow the "reserve method," announcing its non-acquiescence to the *Northern Natural Gas* case in Revenue Ruling 60-317,<sup>23</sup> which stated that rights-of-way have an indeterminable useful life and are not depreciable as based upon the asserted life of proven oil or gas reserves. The Revenue Service clarified its position in Revenue Ruling 65-264,<sup>24</sup> ruling that oil or gas right-of-way cost incurred in connection with their acquisition, and certain other expenditures, may be depreciated where the taxpayer can factually demonstrate that such costs will have a limited useful life because the intangible right-of-way will no longer be useful after the expiration of the useful life of the related pipeline.

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<sup>19</sup> 277 F.2d 128 (8th Cir. 1960).

<sup>20</sup> 266 F. Supp. 298 (E.D. Va. 1966).

<sup>21</sup> *Id.* at 299-300.

<sup>22</sup> *Shell Pipe Line Corp. v. United States*, 267 F. Supp. 1014, 1022 (S.D. Tex. 1967).

<sup>23</sup> 1960-2 CUM. BULL. 452.

<sup>24</sup> 1965-2 CUM. BULL. 53.

## II. SHELL PIPE LINE CORP. v. UNITED STATES

*Shell* is a case of first impression, both as to oil pipelines and as to the method of estimating the useful life of the rights-of-way.<sup>25</sup> Rather than basing its estimation on the "reserve method," Shell used the "annual rate method" to show that the useful life of its trunk rights-of-way was limited by the useful life of the related pipeline.<sup>26</sup> The Government conceded that Shell's evidence was sufficient to establish the useful life of its secondary trunk line rights-of-way, but not its primary trunk line rights-of-way. As a result, Shell claimed that the Government's position was inconsistent. They contended that if their evidence of their experience was sufficient to establish the useful life of some of their trunk line rights-of-way, it should have been sufficient to establish the useful life of all of them. Shell's reasoning was that their classification of trunk lines as primary and secondary was purely arbitrary and was not required by the uniform system of accounts as prescribed by the Interstate Commerce Commission. This argument is questionable since it is a well-settled rule that neither the Government nor the taxpayer may establish tax liability by reliance on the requirements of a regulatory agency.<sup>27</sup>

Shell also claimed that the Government's concession was inconsistent with their position in *Northern Natural Gas Co. v. O'Malley*,<sup>28</sup> where they argued that the "reserve method" of determining the useful life of rights-of-way was unacceptable for depreciation purposes. In that case, the Government maintained that as proven reserves were used up new reserves or new fields often became available to replace them in whole or in part. On the other hand, in the *Shell* case the Government conceded that the useful life of the secondary trunk lines was limited by the life of the oil reserves in the particular areas or fields which they served. The Government's position in the two cases can be defended as consistent by distinguishing between rights-of-way which serve a large producing area of the country and rights-of-way which serve particular fields or areas.<sup>29</sup>

The Government, relying heavily upon *Commissioner v. Indiana Broadcasting Corp.*,<sup>30</sup> argued that Shell's statistical data was not adequate to establish the useful life of a particular right-of-way with reasonable accu-

<sup>25</sup> The other two cases dealing with the depreciation of rights-of-way involved gas pipelines and followed the "reserve method." *Northern Natural Gas Co. v. O'Malley*, 277 F.2d 128 (8th Cir. 1960); *Commonwealth Natural Gas Corp. v. United States*, 266 F. Supp. 298 (E.D. Va. 1966).

<sup>26</sup> The "annual rate method" is based upon retirements of acquisitions by age group. From this data, the actual survivorship rate and the percentage surviving at each age interval are calculated. Using actuarial methods similar to those used to determine mortality curves and life expectancy tables for human beings, the average useful life of the trunk line rights-of-way is determined.

<sup>27</sup> *Old Colony Ry. v. Commissioner*, 284 U.S. 552, 562 (1932).

<sup>28</sup> 277 F.2d 128 (8th Cir. 1960).

<sup>29</sup> Authority for the Government to make this distinction is in Rev. Rul. 65-264, 1965-2 CUM. BULL. 53, which clarified the Revenue Service's previous position as expressed in Rev. Rul. 60-317, 1960-2 CUM. BULL. 452. The earlier ruling simply stated that the Government would not follow the decision in the *Northern Natural Gas Co. v. O'Malley* case, which held that right-of-way easement costs were depreciable. This position was modified in the latter ruling when the Revenue Service stated "if the taxpayer can demonstrate in a particular case that certain easement acquisition costs will have a limited life because they will no longer be useful after the expiration of the useful life of a related pipeline, then such costs may be depreciated."

<sup>30</sup> 350 F.2d 580 (7th Cir. 1965).

acy. In *Indiana Broadcasting* the taxpayer introduced statistical data and analysis of all the network affiliation contracts from the beginning of the television industry in an effort to establish the useful life of an affiliation contract by the general experience in the industry. The court in *Indiana Broadcasting*, however, denied the validity of the statistical analysis noting that since "each contract is more unique than generic," it is "questionable whether any meaningful general experience could ever be shown."<sup>31</sup> Although the main thrust of the *Indiana Broadcasting* case was that each affiliation contract was unique, the court mentioned also that the taxpayer's statistical data did not provide a reasonable norm for prediction in the future because the analysis related to television's infancy, a period marked by a "state of flux."<sup>32</sup> The record in *Indiana Broadcasting* indicated also that the prospects were that the affiliation contracts might increase in value, or at least might not be reduced in value over the years, and therefore were not wasting assets.

The court in *Shell* dismissed the *Indiana Broadcasting* case as not being "particularly apposite."<sup>33</sup> Although the court did not indicate why *Indiana Broadcasting* was not authority for *Shell*, some distinguishing features may be noted. First, *Shell* did not rely solely on statistical averaging of industry-wide experience as it introduced sufficient statistical data to show its own experience with respect to right-of-way retirement policy and practice. Second, and perhaps the most effective rebuttal to the argument in the *Indiana Broadcasting* case is the fact that, even though in theory each right-of-way might be unique, *Shell*'s statistics showed that in this case the useful life of each right-of-way was directly related to the useful life of the related pipeline. *Shell* was thus able to demonstrate a meaningful correlation between the useful life of a particular right-of-way and the average useful life of all the company's rights-of-way. Third, the state of flux and instability in the television industry has not been as prevalent in the oil and gas pipeline industry. Finally, neither the Government nor the taxpayer ever questioned that the rights-of-way were wasting assets. All agreed that their usefulness was limited; it was merely a question of whether their useful life could be estimated with anything approaching "reasonable accuracy."

The Government also attacked the validity of *Shell*'s statistical analysis because of the underlying data upon which it was based. *Shell*'s graphs were based on its system of accounting and conformed with the uniform system of accounts prescribed by the Interstate Commerce Commission.<sup>34</sup> Under this system of accounting, for each retirement of line pipe there will be retired the associated right-of-way cost. As a result, there will necessarily be a close correlation in any graph or analysis of line pipe and right-of-way retirements. Citing the rule that taxes cannot be determined by reli-

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<sup>31</sup> *Id.* at 583.

<sup>32</sup> *Id.* at 584.

<sup>33</sup> *Shell Pipe Line Corp. v. United States*, 267 F. Supp. 1014, 1021 (S.D. Tex. 1967).

<sup>34</sup> In 1934 the Interstate Commerce Commission issued Docket No. 19200 entitled *Depreciation Charges of Carriers by Pipelines*, 205 I.C.C. 33 (1934), requiring all common carriers by pipelines to make annual depreciation deductions on rights-of-way and other classes of carrier property.

ance on the accounting requirements of a regulatory agency,<sup>35</sup> the Government maintained that Shell's analysis was not conclusive for tax purposes because the Interstate Commerce Commission practices of retiring rights-of-way without regard to their continued utility was clearly in conflict with the appropriate tax standards. This contention by the Government seems incorrect because the Interstate Commerce Commission retirement regulations<sup>36</sup> and the Treasury retirement regulations<sup>37</sup> defining retirement are substantially the same.

Because of the presence of "second line rights" in a substantial number of the rights-of-way agreements, the Government argued that Shell's investment in rights-of-way had value and utility beyond accommodating the original pipeline. These "second line rights," it was argued, allowed Shell to extend the useful life of its primary trunk line rights-of-way beyond the actual life of the original pipeline, thereby rendering it impossible to estimate with reasonable accuracy the useful life of such rights-of-way. This argument was premised on the assumption that these "second line rights" gave Shell an unlimited and unqualified right to lay additional pipelines. This is true only where Shell had obtained "second line rights" from every landowner for a particular pipeline. And even when Shell had the right to construct additional lines, it could not do so until it paid the landowner the additional consideration called for in the original agreement. The court pointed out that "[r]ather than basing its argument on the depletion of the source of supply, . . . [Shell] argued that its experience and that of the industry, shows that despite the value of second line rights when the life of the pipe in a line is exhausted, it frequently happens by reason of economic factors or advances in technology that a new location is selected, and the right-of-way, as well as the pipe, becomes valueless."<sup>38</sup> The question is whether the court's reliance on "frequently happened" is sufficient to constitute "reasonable accuracy." Assuming that it is sufficient, the court in *Shell* properly disregarded the presence of "second line rights" in determining that the economic life of the primary trunk line rights-of-way could be shown with the reasonable accuracy required by the regulations to permit the depreciation deduction.<sup>39</sup>

### III. CONCLUSION

*Shell Pipe Line Corp. v. United States* is the first oil pipeline right-of-way easement case to be decided. Two other cases<sup>40</sup> involving the deprecia-

<sup>35</sup> *Old Colony Ry. v. Commissioner*, 284 U.S. 552, 562 (1932). "[T]he rules of accounting enforced upon a carrier by the Interstate Commerce Commission are not binding upon the Commissioner, nor may he resort to the rules of that body, made for other purposes, for the determination of tax liability under the revenue acts."

<sup>36</sup> The Uniform System of Accounts for Pipeline Companies Prescribed by Interstate Commerce Commission, 49 C.F.R. 20(i)-24 (1963) provides: "'Property retired' means units of property which have been removed, sold, abandoned, destroyed, or which for any cause have been withdrawn from service . . . ."

<sup>37</sup> Treas. Reg. § 1.167(a)-8 (1956) with respect to "retirements" provides: "[T]he term 'retirement' means the permanent withdrawal of depreciable property from use in the trade or business . . . ."

<sup>38</sup> *Shell Pipe Line Corp. v. United States*, 267 F. Supp. 1014, 1021 (S.D. Tex. 1967).

<sup>39</sup> Treas. Reg. § 1.167(a)-3 (1960).

<sup>40</sup> *Northern Natural Gas Co. v. O'Malley*, 277 F.2d 128 (8th Cir. 1960); *Commonwealth Natural Gas Corp. v. United States*, 266 F. Supp. 298 (E.D. Va. 1966).



tion of gas pipeline right-of-way easements have also been decided. So far the Internal Revenue Service has lost on the merits in all three cases. In these cases the courts have consistently held that all that is required is a "reasonable approximation" or "rough estimate" of the length of useful life of an asset for the taxpayer to be allowed a depreciation deduction.<sup>41</sup> Nevertheless, the Revenue Service has persisted in maintaining that an estimation or approximation was insufficient to comply with the requirement of "reasonable accuracy." It appears that final settlement of the controversy as to where the line is to be drawn must await either a decision by the Supreme Court or a change in the regulations by the Treasury. In the meantime, the taxpayer has three decisions in his favor. It makes little sense for the Revenue Service to continue to refuse to allow any depreciation and distort the taxpayer's income merely because he cannot compute the useful life of the rights-of-way with mathematical precision.

As suggested above, perhaps the problem could be resolved easily by recognizing that the rights-of-way are not intangibles at all, but tangibles, merging with the construction cost, line pipe and other equipment to become one indivisible and inseverable pipeline system. The Revenue Service has recognized that certain expenditures, intangible when viewed individually, become merged into the cost of the tangible asset to which they are related and are depreciable or depletable. For example, intangible drilling costs incurred in drilling an oil well are expensed or capitalized at the election of the taxpayer.<sup>42</sup> Other examples are attorneys' fees and architect, engineering and contractor's fees incurred in the construction of a tangible asset. If the rights-of-way were characterized as tangibles then proof of the useful life of the related pipeline would be far easier.

The importance of *Shell Pipe Line Corp. v. United States* is that its ultimate decision, after appeal, will have a tremendous impact on the oil pipeline and related industries. In fact, presently, there are some twenty-one cases pending in the court of claims and the United States district courts on this very issue. It remains to be seen whether the holding in *Shell*—that the primary trunk line rights-of-way costs incurred by an oil pipeline common carrier are depreciable because such assets have a limited useful life which can be estimated with reasonable accuracy—will stand on appeal.

Robert M. Bandy

## Federal Estate Tax — Fixed Monthly Payments to Surviving Spouse Qualify for the Marital Deduction

Decedent's will set up a trust from which his widow was to be paid a

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<sup>41</sup> See *Northern Natural Gas Co. v. O'Malley*, 277 F.2d 128 (8th Cir. 1960); *Shell Pipe Line Corp. v. United States*, 267 F. Supp. 1014 (S.D. Tex. 1967); *Commonwealth Natural Gas Corp. v. United States*, 266 F. Supp. 298 (E.D. Va. 1966).

<sup>42</sup> Treas. Reg. 1.612-4 (1965).